Surge Petroleum Inc.

2001 Annual Report

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Corporate Profile

Surge Petroleum Inc. is an emerging junior natural gas and oil exploration and development company, headquartered in Calgary, Alberta. Surge was formed on July 1, 2000 as a result of the amalgamation of three small Alberta public companies. Year 2000 statistics where available, are calculated from combining these three predecessor companies.

Surge is focused primarily in Saskatchewan where the Company produces oil, and in Alberta where the production is both oil and natural gas.

The Company trades on the TSX Venture Exchange (formerly the Canadian Venture Exchange) where its common shares are listed under the symbol "SPY".

Annual Meeting

Surge is postponing the Annual Meeting at this time; however, the Company will be holding an Annual Meeting within 15 months of the last Annual Meeting as is required by law. The postponement of the meeting is due to the fact that the Directors of Surge are optimistic that an acquisition or amalgamation will be forthcoming by fall of 2002 and this will negate the requirements for two Annual or Special Meetings of the Shareholders.

ABBREVIATIONS:

bcf	billion cubic feet
bbl	barrel
bbls	barrels
boe	barrel of oil equivalent (6 mcf = 1 boe)
boepd	barrels of oil equivalent per day
bopd	barrels of oil per day
CBM	coal bed methane
mcf	thousand cubic feet
mmcf/day	million cubic feet per day

Corporate Highlights

	2001	2000	% Change
FINANCIAL:			
Revenue, after royalties[1]	$ 1,875,800	$ 1,436,845	+31
Operational cash flow	$ 900,608	$ 532,700	+69
Working capital – positive	$ 29,261	$ 469,411	
Long term debt	0	0	0
Capital expenditures	$ 1,957,651	$ 1,186,676	+65
Common shares issued	13,454,949	11,830,274	0
Profit before ceiling test write down	$ 206,900	$ 249,794	-17
Ceiling test write down, U.S. properties	$ 5,679,343	0	0
General and administrative expenses	$ 165,216	$ 374,853	-55
Line of credit, not used	$ 950,000	$ 950,000	0
Cash flow per share, diluted	$ .08	$ .04	+100
Capital raised	$ 616,893	$ 909,366	0

(1) Royalties averaged 14% of gross revenues in 2001 and 17% in 2000

	2001	2000	% Change
OPERATING:			
Reserves (proven plus one half probable)			
Oil (bbls)	708,000	506,000	+40
Natural Gas (bcf)	3.044	1.487	+105
Natural Gas Liquids (bbls)	1,800	1,900	-5
Operating costs, per boe	$11.80	$ 9.46	+25
Revenue received, per boe	$35.46	$31.08	+14
Finding Costs:			
Proven, per boe	$ 6.55	N/A	
Proven plus one half probable, per boe	$ 3.52	N/A	
Exit production rates – boepd (6:1)	265	123	+104
General and administrative expenses			
Per boe	$ 2.74	$ 6.95	-61

All barrel of oil equivalent (boe) calculations are based on 6 mcf of gas per barrel of oil (6:1)

President's Report to Shareholders

Achievements in 2001:

- Increased capital spending by 65%
- Increased cash flow by 69%
- Increased natural gas reserves by 105%
- Increased oil reserves by 40%
- Increased production by 104%
- Increased revenue by 31%
- Maintained a zero level of debt
- Raised $616,893 in equity

Surge Petroleum Inc. has completed its first full year of operations as at December 31, 2001. The year has been one of transition and growth. The combined management of the three formative companies is now the management of Surge. This group and the staff provide the Company with new direction and a mandate capable of guiding the Company to a position of greater size. Management's history of contributing to and building successful companies will be an asset to the achievement of Surge Petroleum Inc.

Surge has achieved significant levels of growth during the first year of operations, compared to the combined levels of activity of the three predecessor companies.

Outlook for 2002

At the end of 2001, management made a strategic decision to direct the primary oil and gas exploration and development focus towards Canadian properties and reduce activity in the United States. Surge has stated the cost of its U.S. properties at disposition value, which resulted in the write down of $5,679,343. During 2002, Surge plans to divest itself of these U.S. assets. Alternatively, if these assets are not sold during the year, Surge will retain a number of royalty interests for future disposal and use the proceeds to finance acquisitions and development in Canada.

During the first quarter of 2002, the Company drilled its first horizontal well in the Griffin project. The well flowed to surface at rates of between 200 and 250 barrels of oil per day. Current controlled pumping rates are in the range of 150 bopd with stable water cut. The Company has a 50 percent working interest in this prospect and is developing a play to the west with plans to drill a second well in May 2002. The results of this drilling will identify the extent of the project and additional drilling locations.

Surge holds an interest in nine sections of land in central Alberta. The Company believes these lands have positive potential for the drilling of coal bed methane. Management is presently working with a number of joint venture partners to prepare a project with the objective of drilling between four and fourteen wells during 2002. The level of activity will depend upon financing which would be required for both additional land acquisition and drilling activity.

As a result of the merger in 2000, there are a number of small working interests in certain properties, which the Company anticipates selling during 2002. The Company will use these proceeds to acquire additional properties in existing areas, consolidating our interests.

At present, the Company has no long-term debt. Surge is in the process of arranging a new and expanded line of credit with its bankers and in addition, is anticipating a further line of credit that would be available for acquisitions. Surge will continue to manage any debt diligently.

The capital plan for Surge will be approximately $2.8 million. Most of this amount will be financed by cash flow with some debt financing. Capital plans may exceed this amount if the Company enters into a partnership arrangement, raises additional equity, or commodity prices substantially increase.

Management's strategic decision in 2001 relating to the Company's exploration and development focus has resulted in beneficial and encouraging results for our shareholders. In addition to internal growth and the enhancement of shareholder value, the possibilities of potential mergers will be explored.

On Behalf of the Board of Directors

F.P. Elliott

Frank P. Elliott
President & Chief Executive Officer

Operations Review

During 2001 Surge developed two focus areas in Canada.

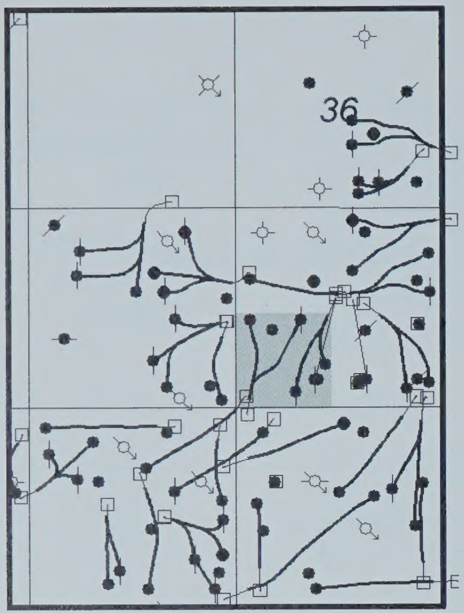
The southeastern Saskatchewan area characterized by:

- Exploitation projects utilizing horizontal wells and waterflood technology
- Low to medium risk
- Immediate cash flow from light and medium oils

The central Alberta area characterized by:

- Shallow gas sands in mature developed areas
- Potential of coal bed methane
- Low cost opportunities with access to existing infrastructure

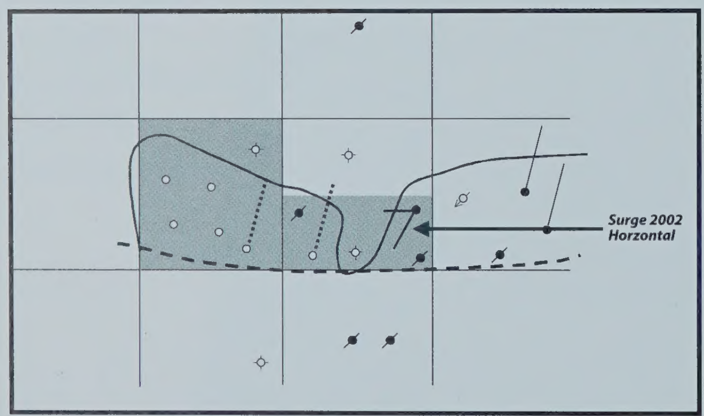
SOUTHEAST SASKATCHEWAN – LOUGHEED



During September and October 2001, Surge initiated and participated in two horizontal wells offsetting a Mississippian Midale waterflood at Lougheed. Surge has 32 percent of the southwest quarter of section 25-6-15 W2M. The two well's initial performance has been excellent with fairly low water cuts and declines. Plans for this land in 2002 include reservoir studies and production pooling with the objective of waterflood implementation.

Legend
- Horizontal Oil Well
- Vertical Oil Well
- Well Injector

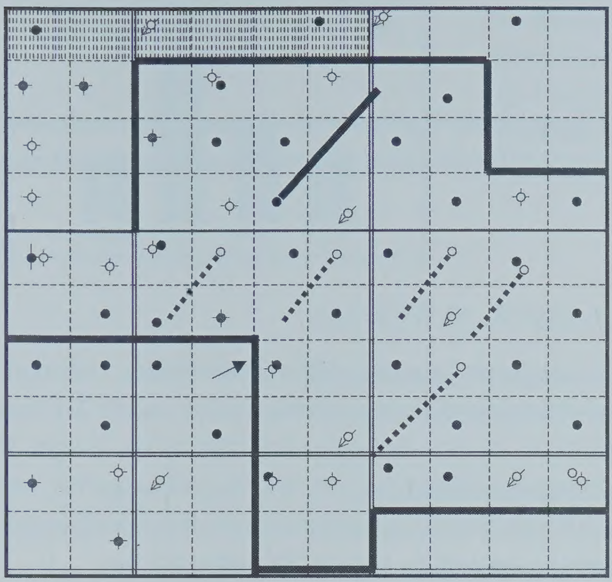
SOUTHEAST SASKATCHEWAN – GRIFFIN



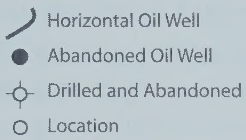
Legend
- Horizontal Oil Well
- Abandoned Oil Well
- Drilled and Abandoned
- Location

Surge initiated a farm-in on one and three quarter sections in the Griffin area. Seismic was run in the fourth quarter and several locations identified. Surge operated and drilled the two legged horizontal well subsequent to year end and is currently evaluating production performance to confirm additional drilling. The Company has a 50 percent working interest in this project.

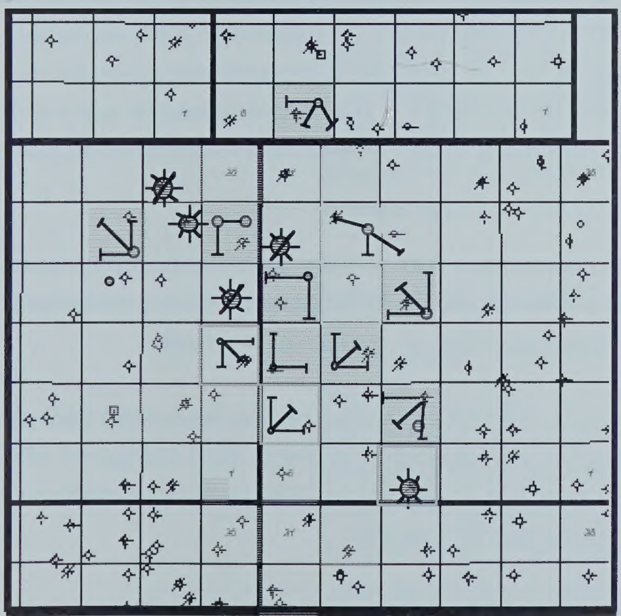
SOUTHEAST SASKATCHEWAN – WORKMAN



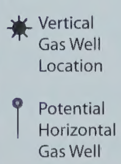
Surge has 15.2 percent working interest in the Workman Voluntary Unit No. 3 producing from the Frobisher zone. During the past 18 months a waterflood commenced resulting in production increases of over 50 percent. The first horizontal well was drilled in the third quarter of 2001 as part of the overall plan to increase unit recovery. This well has so far confirmed predictions of flat stable oil production with low water cuts. Over the next few years, additional horizontal wells will be drilled to enhance production as the waterflood progresses.



CENTRAL ALBERTA – BOS



This shallow gas exploration area consists of medium risk sands at less that 600m in depth. Additionally there is a CBM potential analogous to CBM plays in the Arkoma basin of Oklahoma. This analogous CBM play is characterized by low to negligible water production and exploited with vertical or horizontal wells. A land play is still unfolding in the BOS area and drilling will commence in 2002 once land and partner negotiations are finalized.



OTHER AREAS

Surge's production in other parts of southeast Saskatchewan and Alberta is mature but stable. Some small working interest non-operated minor areas will be divested in 2002.

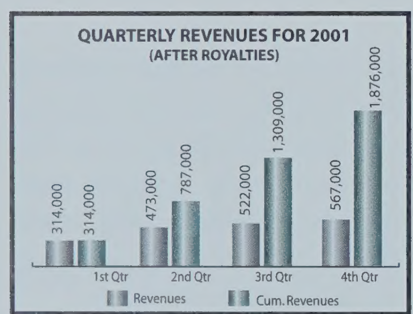
MANAGEMENT'S DISCUSSION AND ANALYSIS

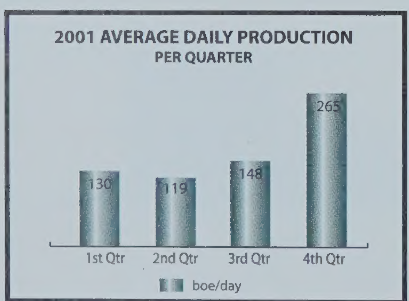
The following discussion and analysis is a review of Surge's historical financial and operating results and should be read in conjunction with the audited consolidated financial statements and accompanying notes.

DESCRIPTION OF BUSINESS

During 2001 the Company's activities were focused equally on Canada and the United States. Canadian activities are located in Saskatchewan and Alberta, while United States activities centre on the Arkoma Basin of eastern Oklahoma and Arkansas. Surge Petroleum Inc. was formed in July 2000 by the merger of three predecessor companies, Plexus Energy Ltd., Peregrine Oil and Gas Ltd., and Aegis Energy Inc. The final stage of this merger was completed in January 2001 when the U.S. subsidiaries of the three predecessor companies were merged with Surge's wholly owned U.S. subsidiary, Arkana Operating Co., Inc.

PRODUCTION, REVENUES AND ROYALTIES

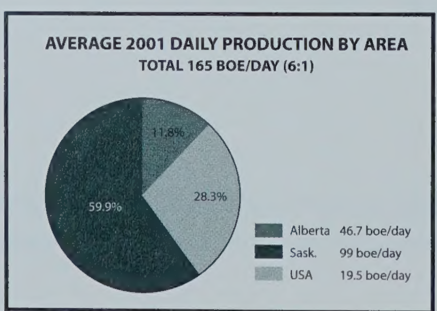


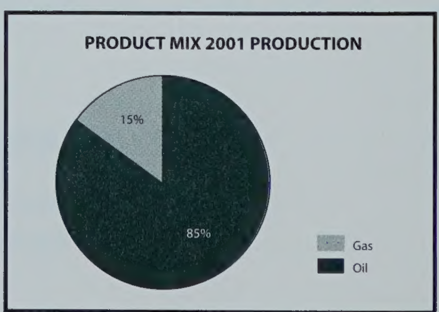


Revenues for 2001, after deduction of royalties, increased 31 percent compared to 2000, to $1,875,800 from $1,436,845. For the three-month period ended December 31, 2001 revenue after royalties was $566,887 compared to $251,038 for the same period of 2000, an increase of 125 percent. The increase was due to new oil wells being brought into production in Saskatchewan and new gas wells in the United States. Canada contributed 88 percent of gross revenues ($1,654,913) while the United States contributed 12 percent of gross revenues ($220,887).

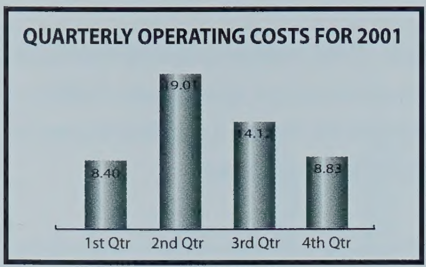
Royalties averaged 14 percent of gross revenues in 2001, a slight decrease from 2000 when the average was 17 percent. Royalty credits for the use of advanced recovery techniques have contributed to the decrease in the proportion of royalties to revenues.

Oil production increased 27 percent to 51,118 bbls or 140 bbls per day from 40,117 bbls or 112 bbls per day in 2000. Gas production was down 50 percent in 2001 compared with 2000 due to the sale of a major gas property in Alberta in 2000 that had contributed significantly to the Company's gas production for that year.





OPERATING COSTS



The Company's average price for crude oil for 2001 was $35.06 compared with $39.29 in 2000, a decrease of 11 percent; however the average gas price increased by 5 percent from $6.03 per mcf to $6.29 per mcf. Operating costs have increased by 25 percent from $9.46 per boe in 2000 to $11.80 per boe in 2001. Rising production costs in the United States were the major cause of this increase.

GENERAL AND ADMINISTRATIVE EXPENSES

Administration costs have declined significantly in 2001 compared with 2000. The cost of administration in 2001 was $165,216 or $2.74 per boe while 2000 cost was $374,853 or $6.95 per boe. The merger of the three founding companies and their U.S. subsidiaries has been the major cause of this reduction. Increasing production from the Company's properties is a secondary factor. Administration costs for the three months ended December 31, 2001 were $67,181 compared with $91,530 for the same period of 2000, a reduction of 26 percent.

RISKS

In the normal course of business, the Company is exposed to market risks resulting from fluctuations in foreign currency exchange rates and commodity prices. The Company attempts to mitigate commodity risks by seeking investment and development prospects that have the potential for a high return on investment. The Company is exposed to changes in exchange rates to the extent that expenditures are incurred for its U.S. properties. Declines in Canadian dollar values against U.S. currency in 2001 have led to increasing costs of developing U.S. properties although to some extent this is mitigated by revenue earned from U.S. properties. To date the Company has not utilized any financial instruments such as forward sales in order to lessen the effect of these risks.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2001, the Company had a working capital surplus of $29,261 down from $469,411 at December 31, 2000. Current assets at December 31, 2001 were $1,002,243, a 16 percent decrease from the December 31, 2000 total of $1,182,164; current liabilities totaled $972,982, a 37 percent increase from 2000 when the total current liabilities were $712,753. Current liabilities include an advance of $370,473 received from partners in a well that the Company drilled at the end of 2001. Costs of drilling this well were not accounted for until the first quarter of 2002. The Company also has a $950,000 line of credit facility that it utilizes from time to time to cover short-term cash requirements. As of December 31, 2001, the line of credit was unutilized.

During the year the Company raised a net of $118,540 from a private placement issue which, together with cash flow from operations, was used to fund drilling activities in both Canada and the United States. A flow through share issue raised further net proceeds of $498,353 which was specifically targeted to drilling activities in Canada. At December 31, 2001 Surge had not spent the flow through monies.

CAPITAL EXPENDITURES

The capital cost of the Company's drilling activities during 2001 was $1.96 million of which $648,206 was spent in the three months ended December 31, 2001. Capital expenditures in Canada were $880,512 compared with $2,518 in 2000. Two horizontal wells were completed in the Lougheed area of Saskatchewan and a third well was completed in the Workman area of Saskatchewan.

In the United States a total of $1,077,139 was spent on drilling and completion activities, compared to $313,549 in 2000. The Company drilled five new gas wells, completed a sixth and carried out a major work over on a producing oil well. Of the new wells, two are producing, and four are shut in pending evaluation for sale or further development of the surrounding prospects. At December 31, 2001 the Company was committed to drill one well in Canada at an estimated total cost of $847,370; the Company's share of this well is 50 percent.

Financing of capital expenditures was from cash flow and a combination of private placement and flow through share issues.

DEPLETION, AMORTIZATION AND SITE RESTORATION

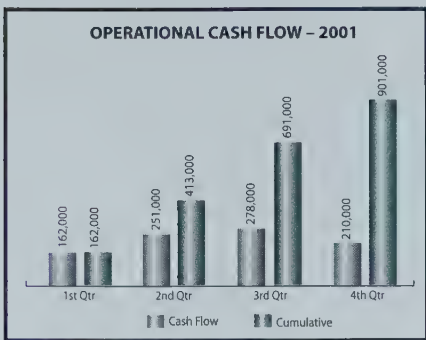
During 2001, the Company recorded a total of $508,042 for depletion and depreciation compared with $174,858 in 2000. The increase was due to three factors: 1) an updated engineering report with revised estimates of the Company's reserves; 2) an increase in the capital cost base due to increased capital expenditures; and 3) inclusion of the United States cost centre as a revenue centre, resulting in a separate depletion charge against U.S. properties. Prior to 2001, the United States cost centre was considered to be in an exploration phase, all production costs were capitalized and no depletion was recorded.

Site restoration charges were $253,837 in 2001 compared to $108,078 in 2000. This increase was also due to the inclusion of the U.S. cost centre as a revenue centre. The accumulated site restoration cost of $285,575 as at December 31, 2001 is the aggregate of these two number less adjustments.

CEILING TEST WRITE DOWN

The Company evaluates its properties annually based on a reserve report produced by an independent engineering company. This report takes into account proven reserves, estimates of possible reserves, year-end prices and future prices trends, as well as future plans for the development of reserves. As a result of its most recent report, dated January 1, 2002, the Company was required to write down the value of its U.S. properties by $5,679,343. Increased costs of acquiring, developing and maintaining U.S. assets due to the falling value of the Canadian dollar, coupled with lower commodity prices were factors contributing to the size of this write down. Additionally, a number of five-year leases on undeveloped property will be expiring in 2002 and the Company has decided not to pursue further development in those areas. With this write down of the U.S. properties, these assets are stated at net realizable value.

NET INCOME AND CASH FLOW



Net income for 2001, before the ceiling test write down was $206,900, a reduction of 17 percent compared to 2000 net income of $249,794. Increased depletion and amortization charges were the primary factor in this reduction of income. Before depletion and amortization, net revenue from operations was $968,779, compared to $532,730 for 2000, an increase of 82 percent. Cash flow from operations in 2001 was $900,608 or $0.08 per share compared to $532,730 or $0.05 per share in 2000, an increase of 69 percent.

The Company had a net operating profit of $170,141 in Canada while the United States operations showed an operating loss of $5,642,584 which included a ceiling test write down of $5,679,343. Before the write down net income in the United States was $36,759.

INCOME TAXES

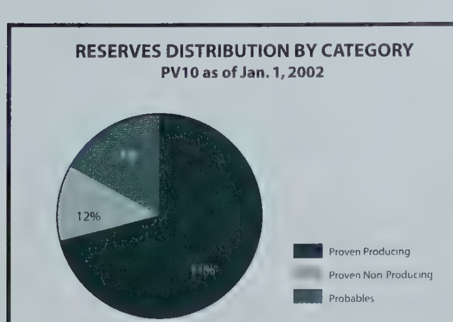
The Company has recognized a future tax asset on its balance sheet reflecting the net tax effect of temporary differences between the carrying value of asset and liabilities for book purposes and the carrying values for tax purposes. A full description of this asset and its components are contained in Note 7 of the Notes to Financial Statements.

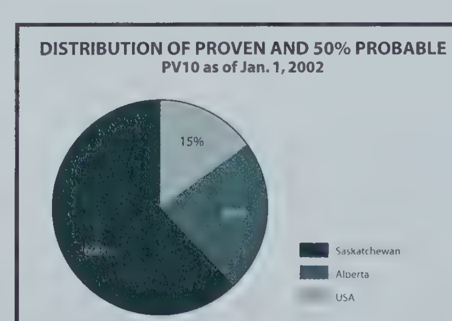
FINANCIAL OUTLOOK

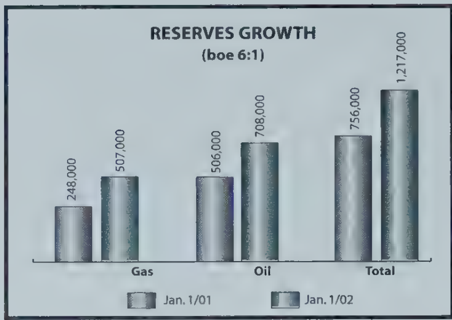
During 2001, there has been a considerable decline in the value of the Canadian dollar compared to the U.S. dollar. As a Canadian company, Surge has been dependent on Canadian sources of revenue in order to finance its exploration activities in the United States. This has meant significant exposure to declining exchange rates. At the same time a buoyant economy in the United States has meant that labour, supplies and equipment costs have become more expensive. During the fourth quarter of 2001 management decided to make Canada the main focus for future acquisitions and development. Budgeted capital expenditures for 2002 are $2.86 million of which $2.36 will be financed from cash flow. All of this capital will be allocated in Canada. An additional $500,000 will be financed from the Company's line of credit. Equity financing will be pursued if market conditions permit. The Company's share price at December 31, 2001 was $0.27.

RESERVES

During 2001, the Company concentrated its capital spending on both its United States properties and its Saskatchewan properties. The results of the combined drilling in these two areas showed an increase in oil reserves of 40 percent and an increase in natural gas resources of 105 percent. The following charts show the mix of production by geographic area and the increase in reserves.







NET ASSET VALUE

The following table calculates the net asset value of the Company at a discount rate of 10 percent before tax as at December 31, 2001, with escalated pricing.

Net Asset Value **(thousands except per share amounts)**	**10%**
NAV @ 10% Before Tax	
Reserves (Chapman Petroleum Jan 1/02)	
– proved producing	$4,659
– proved undeveloped	822
– probable @ 50%	1,121
Undeveloped land	1,688
Working capital	29
Other	496
Total value	$8,815
Number of diluted shares	13,454,949
Net Asset Value Per Share	$0.66

The escalated prices used in the evaluation are as follows:

Price Forecasts (Chapman Petroleum Engineering Ltd.)
Effective January 1, 2002

DATE	**WTI (1)** **$US/STB**	**Alberta Par Price (2)** **$CDN/STB**	**GRP (3)** **$/MMBTU**	**AECO Spot Gas (NIT)** **$/MMBTU**
			CDN$	CDN$
2002	20.00	30.37	3.50	3.61
2003	22.50	34.22	3.75	3.86
2004	23.75	36.14	4.00	4.11
2005	25.00	38.06	4.00	4.11
2006	25.75	39.20	4.12	4.23
2007	26.52	40.38	4.24	4.36
2008	27.32	41.59	4.37	4.49
2009	28.14	42.84	4.50	4.63
2010	28.98	44.12	4.64	4.76

(1)West Texas Intermediate quality (D2/S2) crude landed in Cushing, Oklahoma
(2)Equivalent price for Light Sweet Crude (D2/S2) landed in Edmonton, Alberta after exchange of .650 $US/$CDN and transportation charges of $0.40 CDN/STB.
(3)Gas Reference Price (GRP) represents the average of all system and direct (spot and firm) sales.

Management's Report to the Shareholders'

All information in this Annual Report is the responsibility of Management. The financial statements necessarily include amounts that are based on estimates, which have been objectively developed by Management using all relevant information. The financial information contained elsewhere in this report has been reviewed to ensure consistency with the financial statements.

Management maintains a system of internal accounting control designed to provide reasonable assurance that assets are safeguarded, transactions are properly authorized and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Audit Committee of the Board of Directors has reviewed the financial statements with Management and Davis, Daignault, Schick & Co. The financial statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

Frank P. Elliott
President & Chief Executive Officer
April 30, 2002

Robert R. Hobbs
Chief Financial Officer

Auditors' Report

To the Shareholders of Surge Petroleum Inc.

We have audited the consolidated balance sheets of Surge Petroleum Inc. as at December 31, 2001 and 2000 and the consolidated statements of loss and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2001 and 2000 and the consolidated results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Davis, Daignault, Schick & Co.
Chartered Accountants

CALGARY, Alberta
March 18, 2002

Consolidated Balance Sheet

As at December 31

	2001	2000
ASSETS		
Current		
Cash	$ 43,486	$ 626,709
Accounts Receivable	958,757	555,455
	1,002,243	1,182,164
Investment in private company	83,875	83,875
Capital (Note 3)	3,857,786	8,087,520
Future tax benefits (Note 7)	542,236	—
	$5,486,140	$9,353,559
LIABILITIES		
Current		
Accounts payable and accrued liabilities	$ 789,226	$ 497,454
8% convertible debentures (Note 4)	183,756	215,299
	972,982	712,753
Provision for site restoration costs	285,575	95,450
	1,258,557	808,203
SHAREHOLDERS' EQUITY		
Capital stock (Note 6)	8,831,651	8,295,562
(Deficit) retained earnings	(4,604,068)	249,794
	4,227,583	8,545,356
	$5,486,140	$9,353,559

On behalf of the Board of Directors:

_____________ Director _____________ Director

Consolidated Statement of Loss and Deficit

For the Years Ended December 31

	2001	2000
Revenue		
Oil and gas revenue net of royalties	$1,875,800	$1,436,845
Expenses		
Depletion and amortization	761,879	282,936
General and administrative	165,216	374,853
Interest on long-term debt	30,101	17,393
Well operating	711,704	511,869
	1,668,900	1,187,051
Income before ceiling test write-down	206,900	249,794
Ceiling test write-down (Notes 1 and 3)	5,679,343	—
(Loss) income before income taxes	(5,472,443)	249,794
Income taxes (recovery)		
Current	4,459	—
Future (Note 7)	(623,040)	—
	(618,581)	—
Net (loss) income for the year	(4,853,862)	249,794
Retained earnings (deficit), beginning of year	249,794	(1,369,179)
Organization and other costs written off on amalgamation	—	(498,118)
Applied to share capital	—	1,867,297
(Deficit) retained earnings, end of year	$(4,604,068)	$ 249,794
(Loss) income per share:		
Basic	$(0.41)	$0.02
Diluted	$(0.41)	$0.02
Weighted average number of shares outstanding:		
Basic	11,799,363	11,017,756

Consolidated Statements of Cash Flows

For the Years Ended December 31

	2001	2000
Operating Activities:		
Net (loss) income for the year	$(4,853,862)	$249,794
Adjustments to reconcile income from operations to net cash provided:		
Ceiling test write-down	5,679,343	—
Depletion and amortization	508,042	174,858
Provision for site restoration	253,837	108,078
Current restoration charges	(63,712)	—
Future income taxes	(623,040)	—
	900,608	532,730
Changes in operating assets and liabilities:		
Accounts receivable	(403,302)	(227,224)
Accounts payable and accrued liabilities	291,772	235,362
Accrued debenture interest	(6,543)	(32,724)
Cash flows from operating activities	782,535	508,144
Investing activities:		
Sale of capital assets	—	870,609
Investment in private company	—	(80,432)
Capital assets acquired	(1,957,651)	(1,186,676)
Cash flows used in investing activities	(1,957,651)	(396,499)
Financing activities:		
Repayment of long-term debt	—	(130,000)
8% convertible debentures	(25,000)	(456,000)
Proceeds of share issue, net of issue costs	616,893	909,366
Cash flows from financing activities	591,893	323,366
Net (decrease) increase in cash	(583,223)	435,011
Cash, beginning of year	626,709	191,698
Cash, end of year	$ 43,486	$ 626,709
Cash flow per share:		
Basic	$0.08	$0.05
Diluted	$0.08	$0.04
Supplementary information:		
Interest paid	$ 36,644	$ 50,117
Taxes paid	$ —	$ —

Notes to Financial Statements

1. Basis of Presentation

The Company's activities over the past five years have been primarily directed towards the acquisition, exploration and development of natural Gas properties in Oklahoma and Arkansas.

As at December 31, 2001, the Company made a strategic decision to change its primary oil and gas exploration focus and direct its efforts and finances towards its Canadian properties and to reduce its focus on its United States properties.

The Company has decided that its objective for 2002 will be to divest its interests in the United States and has decided to state the value of these properties and lands at net realizable value. The results of this decision is that the Company has recorded a ceiling test write-down of $5,679,343, which has been recorded on the December 31, 2001 financial statements (see Note 3).

2. Significant Accounting Policies

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect the following policies:

a) Business combination

Surge Petroleum Inc. was formed on July 1, 2000 through the amalgamation of Aegis Energy Ltd. (Aegis), Plexus Energy Ltd. (Plexus), and Peregrine Oil and Gas Ltd. (Peregrine). Prior to the amalgamation, Aegis, Plexus and Peregrine were under common control in that the companies had a high percentage of common equity holders, common directors and operated in many of the same geographic areas. The combination has, therefore, been accounted for in a manner similar to the pooling of interest method whereby the consolidated financial statements reflect the combined carrying values of the assets, liabilities and shareholders' equity and the combined operating results of Aegis, Plexus and Peregrine for all periods presented, both pre and post amalgamation.

Under the terms of the amalgamation arrangement each Aegis shareholder received one Surge common share in exchange for 3.3 Aegis shares, each Plexus shareholder received one Surge common share in exchange for 2.8225 Plexus shares, and each Peregrine shareholder received one Surge share in exchange for 3.6474 shares.

A summary of the book values of the assets and liabilities at the date of the amalgamation is presented below:

	Aegis	Plexus	Peregrine
Assets:			
Current	$ 259,724	$ 202,651	$ 130,303
Capital	1,099,760	3,036,481	3,887,456
Other	234,432	38,000	41,633
	1,593,916	3,277,132	4,059,392
Less:			
Current liabilities	240,719	137,632	130,867
Future removal and site restoration costs	13,400	13,023	16,777
Net assets	$1,339,797	$3,126,477	$3,911,748

The accumulated deficit of the combined companies at the amalgamation date was reduced to nil by a charge to share capital.

b) Basis of consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned U.S. subsidiaries; AJS Energy Inc, Arkana Operating Co., Inc., Peregrine Oil and Gas Inc., and Plexus Resources Inc., all of which were amalgamated on January 31, 2001. The amalgamated subsidiary continues under the name of Arkana Operating Co., Inc.

c) Petroleum and natural gas properties

The Company follows the full cost method of accounting for oil and gas operations, whereby all costs associated with the exploration for, and development of, oil and natural gas reserves are capitalized by cost center. The Company operates in two cost centers, Canada and the United States of America. Such costs include property acquisition expenditures, geological and geophysical expenses, carrying charges of non-productive properties, costs of drilling productive and non-productive wells, and plant and production equipment costs. Financing and administrative costs are capitalized only to the extent that they are directly related to capital projects. Proceeds from the sale of any interests in oil and gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a disposition would alter the rate of depletion by at least 20%.

Costs of acquiring and evaluating unproved properties are initially excluded from the costs subject to depletion and amortization. These properties are assessed regularly to ascertain whether impairment has occurred. When production commences or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to the costs subject to depletion and amortization.

Costs accumulated by the cost centre are depleted using the unit of production method based on estimated net proven reserves, as determined by the Company and reviewed yearly by independent consulting engineers. Natural gas production and reserves are converted to equivalent units of measure using a relative energy content.

The Company applies a ceiling test to the costs of developed properties to ensure that capitalized costs (net of accumulated depletion) do not exceed the estimated future net revenues from production of proven reserves less estimated future administrative, financing and income tax costs. Future net revenues are based on prices and costs prevailing at the year end.

d) Other capital assets

Amortization of other equipment is provided using the declining balance method at rates ranging from 20% to 30% per annum.

e) Future site restoration costs

Estimated future site restoration and reclamation costs are amortized using the unit of production method. These costs are based on management's estimates of the anticipated costs of site restoration net of expected recoveries. The estimates are based on current costs, existing legislation and industry standards. Actual removal and site restoration costs are charged against the accumulated provision as incurred. In the current year $63,712 (2000 - $nil) of actual costs were charged against the provision.

f) Measurement uncertainty

The amounts recorded for depletion and amortization of capital assets and the provision for future site restoration costs, are based on estimates of reserves and future costs. By their nature, these estimates and those related to future cash flows used to assess impairment are subject to measurement uncertainty and the impact on future financial statements resulting from changes in such estimates could be material.

g) Joint ventures

Substantially all of the Company's oil and gas related activities are conducted jointly with others and, accordingly, these consolidated financial statements reflect only the Company's proportionate interest in such activities.

h) Flow-through shares

The Company finances a portion of its exploration and development activities through the issue of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Company, share capital is reduced and future income taxes are increased by the estimated amount of future income taxes payable when the expenditures are incurred and renounced to the subscribers.

i) Investments

Long-term investments are carried at cost less permanent declines in value.

j) Earnings and cash flow per share

Effective January 1, 2001, the Company adopted the new Canadian Institute of Chartered Accountants' recommendations for determining per share amounts. The new standard utilizes the treasury stock method in the determination of diluted per share amounts. Under this method, the diluted weighted average number of shares is calculated assuming the proceeds that arise from the exercise of outstanding "in the money" options and warrants are used to purchase shares of the Company at their average market price for the period. Comparative per share amounts for 2000 have been restated.

Prior to the adoption of the new recommendation, diluted per share amounts were determined using the imputed earnings method. The effect of this change did not result in a material change in the per share amounts reported.

k) Foreign currency translation

Financial statements of the Company's foreign subsidiary are translated using the temporal method whereby all monetary assets and liabilities are translated at the rate of exchange at the balance sheet date. Non-monetary assets and liabilities are translated at exchange rates prevailing at the transaction date. Income and expenses are translated at rates which approximate those in effect on transaction dates. Gains and losses arising from restatement of foreign currency monetary assets and liabilities for each period end are included in earnings.

l) Stock-based compensation plans

The Company grants options in accordance with the policies of the Canadian Venture Exchange. No compensation expense is recognized when stock options are granted. Consideration paid for the shares on exercise of the stock options is credited to capital stock.

m) Financial instruments

The Company's financial instruments are comprised of accounts receivable, accounts payable and accrued liabilities and convertible debentures.

i) Fair value of financial assets and liabilities

The fair values of financial instruments approximate their carrying amount due to the short term maturity or capacity for prompt liquidation.

ii) Credit risk

Virtually all of the Company's accounts receivable are with customers in the oil and gas industry and are subject to normal industry credit risks.

iii) Foreign currency risk

The Company is exposed to foreign currency fluctuations as oil and gas prices received are based on U.S. dollar denominated prices.

3. Capital Assets

i) 2001:

	Cost	Accumulated Amortization	Net Book Value
Oil and gas properties	$11,852,557	$8,050,900	$3,801,657
Other equipment	110,821	54,692	56,129
	$11,963,378	$8,105,592	$3,857,786

ii) 2000

	Cost	Accumulated Amortization	Net Book Value
Oil and gas properties	$ 9,906,140	$1,879,123	$8,027,017
Other equipment	99,589	39,086	60,503
	$10,005,729	$1,918,209	$8,087,520

Accumulated amortization includes a $5,679,343 ceiling test write-down of U.S. oil and gas properties recorded in the current year.

During the year ended December 31, 2001, the Company capitalized $ nil (2000 - $264,480) of general and administrative expenditure relating to exploration and pre-production activities.

The cost of unproved property excluded from the depletion base as at December 31, 2001 was $1,072,905 (2000 - $6,632,262).

4. 8% Series I Convertible Debentures

The Company has pledged as security for the debentures all of the issued and outstanding shares of its wholly owned subsidiary and an interest in an oil well. The debentures, with a term of one year, are convertible into common shares of the corporation at the election of the holders based on the average trading price of the common shares. On January 17, 2001, the convertible debentures were converted to 8% Series I debentures with the same security and conversion rights as the prior 8% Series II debentures of the predecessor companies. The 8% Series I debentures are due on January 1, 2002. These debentures have been subordinated to the bank credit facility described in Note 5. Subject to consent from the bank, it is the Company's intention to repay the debentures.

5. Long-Term debt

The Company has an undrawn bank credit facility available to a maximum of $950,000 at December 31, 2001. This loan has no fixed terms of repayment and is subject to a periodic review by the lender. Amounts outstanding bear interest at bank prime plus 1.0% and are secured by a $5,000,000 floating debenture and general security agreement over the Company's assets.

6. Share Capital

a) Authorized

An unlimited number of Class "A" common shares

An unlimited number of Class "B" preferred shares

b) Issued:

	Number of Common Shares	$
Balance, December 31, 1999	10,270,341	$9,132,477
Private placement	474,729	332,310
Flow through share private placement	255,500	178,850
Debentures converted	729,704	504,023
Issued pursuant to management compensation plan (Note 6d)		
— vested	45,788	36,630
— non-vested	54,212	–
Share issued costs	–	(21,431)
Pre-amalgamation deficit applied to share capital	–	(1,867,297)
Balance, December 31, 2000	11,830,274	8,295,562
Shares cancelled	(94,644)	–
Issued pursuant to management compensation plan (Note 6d)		
— prior years' shares vesting in current year	–	43,370
— vested	40,909	18,000
— non-vested	40,910	–
Private placement issue	350,000	122,500
Flow-through share issue	1,287,500	515,000
Estimated tax benefits renounced on flow-through shares - 2000	–	(80,804)
Share issue cost	–	(81,977)
Balance, December 31, 2001	13,454,949	$8,831,651

c) Share purchase warrants outstanding

Balance December 31, 2000	Price	Exercise Expiry Date	Expired	Issued	Balance December 31, 2001
35,430	$0.85	April, 2001	(35,430)	–	–
27,417	$1.09	April, 2001	(27,417)	–	–
85,715	$0.75	May, 2001	(85,715)	–	–
151,650	$0.75	June, 2001	(151,650)	–	–
–	$0.65	April, 2003	–	100,000	100,000
–	$0.40	December, 2002	–	289,625	289,625
300,212			(300,212)	389,625	389,625

d) Stock based compensation plans

The Company has a stock option plan that permits the Board of Directors to grant stock options to employees, directors and officers and persons or companies who provide services to the Company. Under the plan, the Company is authorized to issue options to purchase, in aggregate, up to 10% of the issued and outstanding common shares. The options vest upon granting and expire not more than five years from the date on which the options were granted.

Year Option Granted	Expiry Date	Options Outstanding	Exercise Price
1997	June 18, 2002	69,191	$0.50
1999	June 23, 2004	9,091	$0.56
1999	June 23, 2004	4,545	$0.66
2000	July 13, 2005	80,000	$0.70
2000	July 13, 2005	890,814	$0.90
		1,053,641	

During the year the Company entered into contracts with certain senior management whereby it issued 81,819 (2000 – 100,000) common shares. These shares vest with the management upon completion of the service contracts. The company has recorded share capital and general and administrative expenses of $61,370 (2000 - $36,630) related to these contracts. At December 31, 2001, 40,910 (2000 – 54,212) shares remain unvested.

e) Flow-through shares

On December 31, 2001, the Company completed the private placement of 1,287,500 (2000 – 255,500) flow-through Class "A" common shares at $0.40 (2000 - $0.70) per share. Under the terms of the flow-through share agreement, the Company has committed to incur $515,000 of resource expenditure by December 31, 2002.

f) Trading restrictions

None (2000 – 482,885) of the issued shares are subject to escrow trading restrictions.

7. Income Taxes

Income taxes differ from the results which would be obtained by applying the combined federal and provincial income tax rates to earnings before income taxes.

The difference results from the following:

	2001	2000
Effective tax rate	45.18%	45.38%
Expected income tax expense (recovery)	$(2,472,450)	$113,357
Non-deductible Crown payments, net of ARTC	49,592	32,657
Resource allowance	(35,792)	(46,969)
Recognition of tax benefits not previously recorded	(729,008)	(99,045)
Tax benefit of ceiling test write-down of U.S. properties not recorded	2,565,927	–
Effect of changing tax rates	3,150	–
	$ (618,581)	$ –

At December 31, 2001, the Company had estimated non-capital losses of $665,201 (2000 - $779,335) which may be available to offset future Canadian taxes and non-capital losses of $5,126,467 (2000 - $4,531,876) which may be available to offset future income taxes in the United States.

In addition, the Company has tax pools related to exploration and development and unamortized capital costs of $2,188,692 (2000 - $1,945,835) which may be available for deduction against future Canadian taxable income and $5,712,947 (2000 - $4,651,678) which may be available for deduction against future taxable income in the United States.

Future income taxes reflect the net tax effects of temporary differences between the carrying value of assets and liabilities for book purposes and the carrying values for tax purposes. Due to the change in operating emphasis and the profitability of the Canadian operations, the Company recognized the future tax benefit on the Canadian losses carried forward and tax pools for the year ended December 31, 2001. In past years, the Company had taken a full valuation allowance against the future tax asset. The components of the future income tax asset are as follows:

Tax pools in excess of net book value of capital assets	$1,827,013
Non-capital losses	2,616,675
Provision for site restoration	180,292
Share issuance expenses	45,707
	4,669,687
Valuation allowance on U.S. tax pools and non-capital losses	(4,127,451)
Future tax asset	$ 542,236

8. Segmented Information

The Company is involved in the exploration and development of petroleum and natural gas properties in Canada and the United States of America. Operations and identifiable assets by geographic region are as follows:

	2001	2000
Revenue		
Canada	$1,654,913	$1,436,845
United States	220,887	–
Operating income (loss)		
Canada	70,141	249,794
United States	(5,642,584)	–
Identifiable assets		
Canada	3,046,755	2,413,313
United States	2,439,385	6,940,246
Capital expenditures		
Canada	880,512	2,518
United States	1,077,139	313,549

9. Related party transactions

a) Consulting fees of $195,395 (2000 - $96,155) were paid to companies controlled by directors of Surge Petroleum Inc.

b) 8% convertible debentures and accrued interest in the amount of $183,756 (2000 - $215,299) are held by companies controlled by the President and Chief Financial Officer of Surge Petroleum Inc. (see Note 4).

c) During the year, the Company entered into an agreement with companies controlled by the President and Chief Financial Officer to participate in the drilling of a well in the United States. The well was unsuccessful and abandoned. As a result of these agreements, accounts receivable includes $93,857 due from the Company controlled by the President and $55,285 due from the Company controlled by the Chief Financial Officer. It is the intention of the Company, subject to the approval of the Company's bank, to partially offset the convertible debentures (see Note 4) against these receivables.

10. Commitments

The Company is committed under a lease agreement for the rental of premises to the following annual payments, exclusive of realty taxes and other charges:

2002	$ 43,368
2003	43,368
2004	43,368
2005	28,912

11. Comparative Figures

The comparative figures have been reclassified to conform with the current year's presentation.

Corporate Information

OFFICERS AND DIRECTORS

Frank P. Elliott, P.Geol.
Director, President & Chief Executive Officer

Robert R. Hobbs, C.M.A.
Chief Financial Officer, Corporate Secretary

Peter D. Sametz, P.Eng.
Director, Chief Operating Officer

Gregory C. Collver, Barrister & Solicitor
Director

Jeffrey J. Scott, M.B.A.
Director

Carol Mohitpour, BSc.
Controller

Dawn Bishop, B.Comm.
Assistant Corporate Secretary

HEAD OFFICE

Suite 1200, 736 – 6th Avenue S.W.
Calgary, Alberta
T2P 3T7
Telephone: (403) 262-4937
Facsimile: (403) 264-5505
E-Mail: info@surgepetroleum.com
Website: www.surgepetroleum.com

BANKERS
National Bank of Canada
Calgary, Alberta, Canada

EVALUATION ENGINEERS
Chapman Petroleum Engineering Ltd.
Calgary, Alberta, Canada

AUDITORS
Davis Daignault Schick & Co.
Calgary, Alberta, Canada

TRANSFER AGENT
Computershare Trust Company of Canada

SHARES LISTED
TSX Venture Exchange
Stock Symbol "SPY"

LEGAL
Gregory C. Collver
Paul D. Trotter

The Annual Information Form may be obtained on request by calling the Company.

Key Objectives

Wealth Development:

- *Accelerate production growth within the southeast Saskatchewan focus area*
    - *through horizontal drilling*
    - *through waterflood enhancement*
    - *through drilling field extension wells*

New Initiatives:

- *Finalize a joint venture for shallow gas and coal bed methane development and commence shallow drilling in the central Alberta focus area.*

- *Actively pursue merger opportunities with the intention of adding value through attaining critical mass in cash flow, personnel and tax optimization.*

- *Finalize a "wide area" farm-in to explore for new pools in the Company's core areas.*

Communication with Shareholders:

- *Enhance reporting to shareholders and potential shareholders*

- *Recognition from the investment community*

Suite 1200, 736 - 6th Avenue S.W., Calgary, Alberta T2P 3T7
Telephone: (403) 262-4937   Fax: (403) 264-5505
info@surgepetroleum.com   www.surgepetroleum.com